First Trust
Monday Morning OUTLOOK
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# Fear of Debt Spiral Misplaced

**Brian S. Wesbury** – *Chief Economist*
**Robert Stein, CFA** – Dep. Chief *Economist*
**Strider Elass** – *Economist*

Now that things have settled down in Washington DC, politicians are focusing on a "grand compromise" to fix the budget. Without reform, growth in entitlements will eventually push federal spending back to levels last seen in World War II.

While there are all kinds of things to worry about in any negotiations about entitlements, some analysts are spreading an even more horrifying story. They say low interest rates are hiding a potential catastrophe. Once interest rates rise, they claim, the budget and the total debt of $17 trillion are going to soar with interest costs boosting spending so fast that deficits will turn into an uncontrollable death spiral.

Right now the federal debt is $17 trillion. And, if interest rates rise from artificially low 0%, 1%, 2.5% levels, to more sustainable rates of closer to 4%, look out below. On $17 trillion, that could mean an extra $500 billion per year in interest costs, a huge jump considering that in 2013 net interest costs were only $220 billion. This will force more borrowing and even more debt and even more interest costs down the road.

But, this theory has several major holes. First, the relevant debt for calculating the impact of a change in interest rates is not $17 trillion. The government owns about $7 trillion of its own debt, including IOUs held by the Social Security Trust Fund (with only accounting interest costs) and bonds held at the Fed (where the interest goes back to the Treasury). This creates other problems, but it limits the impact of rising rates on the budget. Excluding these, leaves roughly $10 trillion in debt.

Second, although interest rates on newly-issued debt averaged about 1% this spring, some debt was financed years ago at higher rates. As a result, the average maturity of the debt is about 4½ years and its average interest rate is about 2%. So, if rates go back to 4%, that would generate an additional cost of $200 billion per year (2 extra points applied to $10 trillion), not the $500 billion that hysterical analysis promotes.

Of course, the extra $200 billion per year is still a lot of money; it's about 1.5% of GDP. That $200 billion plus the debt service costs we already have would put us at about 2½% of GDP, no higher than they were from 1984 to 1998, when the US economy did quite well.

Third, the extra costs won't happen overnight; they'll take several years to filter through after we get higher rates, because the Treasury doesn't have to roll over the entire debt every year. The average maturity of 4½ years means rising costs will roll out more slowly than many people think.

Last, and often overlooked, is that if rates are rising then the economy is probably stronger and taxes are rising faster as well. For example, an extra 1 point in real GDP growth *for only one year* should add more than $30 billion per year in revenue. Economics always has more than one moving part

We're certainly not suggesting things are fine with our fiscal situation. They're not. Long-term reforms are essential. But let's focus on the real long-term threat, not exaggerated threats that seem to be driven from raw fear and not analysis.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 10-28 / 8:15 am | Industrial Production – Oct | +0.4% | **+0.3%** | +0.6% | +0.4% |
| 8:15 am | Capacity Utilization – Oct | 78.0% | **78.0%** | 78.3% | 77.8% |
| 10-29 / 7:30 am | PPI – Oct | +0.2% | **+0.3%** | | +0.3% |
| 7:30 am | "Core" PPI – Oct | +0.1% | **+0.1%** | | 0.0% |
| 7:30 am | Retail Sales – Oct | +0.0% | **+0.1%** | | +0.2% |
| 7:30 am | Retail Sales Ex-Auto – Oct | +0.4% | **+0.6%** | | +0.1% |
| 9:00 am | Business Inventories – Oct | +0.3% | **+0.4%** | | +0.4% |
| 10-30 / 7:30 am | CPI – Oct | +0.2% | **+0.2%** | | +0.1% |
| 7:30 am | "Core" CPI – Oct | +0.2% | **+0.2%** | | +0.1% |
| 10-31 / 7:30 am | Initial Claims – Oct 26 | 340K | **338K** | | 350K |
| 7:30 am | Chicago PMI | 55.0 | **56.8** | | 55.7 |
| 11-1 / 9:00 am | ISM Index – Oct | 55.0 | **55.2** | | 56.2 |
| *afternoon* | Total Car/Truck Sales – Oct | 15.4 Mil | **15.4 Mil** | | 15.2 Mil |
| *afternoon* | Domestic Car/Truck Sales – Oct | 11.8 Mil | **11.8 Mil** | | 11.6 Mil |